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Retirement Security for Illinois Educators
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To the Members of the Governor's Pension Commission:

Thank you for this chance to share our views on funding public pension systems properly. We applaud the commission's efforts in understanding issues that confront Illinois pension systems. We are appreciative of the substantial efforts made to continue the state's unblemished record of complying with the 50-year funding law. In particular, we note the issuance of pension obligation bonds that will have a continuing impact on state contribution requirements for many years to come.

Together we have learned much. From our perspective, the principal problem has been neglect of responsibilities. The neglect spanned five decades, beginning during World War II and continuing into the mid-90s.

You have asked us to share recommendations for meeting the state's current pension funding requirements. For reasons outlined in this letter, the only solution we recommend is continued compliance with the existing funding law.

Benefits

We are dismayed with the focus on benefit reductions because the approach falls far short of meeting existing responsibilities. It is, in fact, the unfunded liability that drives increased funding requirements. If all of the proposed new employee benefit reductions were implemented for new members, state contributions would still be high because the state is responsible for the existing unfunded liability and the constant compounding of interest on the unpaid principal.

Current benefit levels are not out of line. All parties and the analysis by the commission's actuaries agree TRS benefits are essentially middle-of-the road. In fact, TRS members pay more than teachers in other non-Social Security states. Under the proposals before you now, current members will pay more for the same benefits. New participants will pay the increased rate but receive lower benefits.

Other problems would arise from the individual benefit reduction proposals. Capping benefit increases for new hires at two percent on the first $24,000 means members will lose purchasing power rapidly upon retirement. The TRS money purchase feature is a standard element of good plan design and is fair to members and the state. It is based on a statutory six percent interest rate that is set well below our actuarial assumption and the experience of the past 20 years.

Remember, too, that TRS members are not covered by Social Security. The state has consistently opposed coverage for the very sound reason that mandatory coverage increases the total pension/retirement cost. As a result, the TRS plan is far more efficient.

The efficiency comes at the cost of the loss of the Social Security safety net. As a result, one should be extremely skeptical of any defined contribution proposal that overlooks the member's essential economic security.

Funding

In addition to benefit reductions, you are being asked to consider extending the current 50-year funding period. New funding scenarios were prepared for today's meeting that extend the funding period to 70 years. In other words, the funding program would not be complete until a teacher entering the system this year is 82 years old.

It does not take an actuary to conclude that extending the funding period will not save the state money in the long run. The interest clock will continue to run. You cannot fund the pension systems at whatever level is convenient and expect pension funding obligations to go away.

Efficiency and effectiveness

TRS continues ongoing efforts to minimize state funding requirements through careful administration and wise investment of available assets.

- The FY2006 funding request reflects a $12 million reduction by matching the contribution rate from federal funds with the rate paid through the state contribution.
- TRS has exceeded actuarial earnings assumptions when measured over both 10- and 20-year periods. Last year's 16.5 percent investment return resulted in an $18 million reduction in the FY2006 contribution request.
- Our careful control of administrative expenses is demonstrated by overall costs that rank below our sister systems in Illinois and nationwide.

Our recommendation is based on our understanding of the history of state funding. That history shows the state has consistently changed the rules whenever the cost of past irresponsibility grew too great. In an attached perspective, we review some of these past choices. I am hopeful that it will help explain why we urge you to stay the course and comply with the funding law.

Sincerely,

Jon Bauman

Jon Bauman
Executive Director

Attachment: Perspective on State Retirement System Funding

cc: John Frigo, Office of Management and Budget
Lance Weiss, Deloitte Consulting LLP
Howard Freidin, Deloitte Consulting LLP

Perspectives on State Retirement System Funding

Years ago, the state had to pick between saving for pensions to be paid another day and paying for programs that many thought were of immediate importance.

So, money owed the pension systems for benefits being earned went to fund other programs.

Years went by. State funding needs increased faster than state revenue. Pension funding needs grew because state contributions were too low to cover actual costs, much less the interest on previously unpaid contributions. This caused unfunded liabilities to grow, slowly at first, and then much more rapidly. This is very similar to the amount due on a credit card growing when only minimum payments are made.

At one time, state law called on the state to contribute 120 percent of member contributions. This standard was never met.

A seven-year phase-in was enacted in 1989 (Public Act 86-0273) as part of a pension funding reform law. The purpose of the phase-in, or ramp, was to build increased contributions into the state budget over time and avoid the fiscal shock of doing it all at once. Additional funding under PA 86-0273 began in FY1990, in the amount of $30 million, or half the amount specified by the new law.

The 1989 law had no teeth. State contributions were based on whatever had been appropriated the previous year, not the amounts certified by the retirement systems as the amounts required by the funding law. This was the era of "level funding."

In 1994, another funding law was enacted, but it had teeth. Public Act 88-0593 contained a continuing appropriation requirement. Funding was not an option and the General Assembly has faithfully followed this mandate every year since enactment. (This act is often called the 1995 law because the funding requirements first became effective on July 1, 1995.)

By the time the 1995 law was enacted, the systems' unfunded liabilities had grown dramatically. The ramp was 15 years instead of seven because the difference between what the systems were getting and what they needed had grown so much higher. While the ramp spared short-term budget pain, it legalized continued under funding for the next 50 years.

Now we are discussing funding for FY2006, the 11th step on the 15-year ramp. The required contributions are high, and they will continue to increase as anticipated in the 1995 funding law. The ultimate funding levels would have been lower if the unfunded liabilities had not grown so large by 1995 and if the ramp had been shorter. The ramp allows the unfunded liabilities to grow since the required contributions are lower than required under a more standard actuarial funding method.

What has changed since the 1995 funding law? Three things:

1. Asset valuation method: FY1999 and subsequent funding requirements were reduced because assets were valued at market rather than book value.

2. Benefit increases: Illinois pensions were brought closer to national averages. State employees and teachers paid significant portions of the costs. The state pays for about 25 percent of the cost of increasing teacher benefits to the 2.2 formula.

3. Revenue decline / Pension obligation bonds (POBs): State revenues suffered in the wake of the economic downturn that began the new century. While state retirement system assets also declined, they did not cause the increased funding requirements. These were largely due to the ramp. In 2003, the state issued pension obligation bonds to help fund the retirement systems. Appropriations to the retirement systems were reduced by the amount the state owed as debt service. The state contribution for TRS for FY2006 is actually $290 million less than would have been required absent the POBs.

What has not changed?

The state's responsibility to fund pensions as promised did not change.